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IN THE

Supreme Court of the United States

OCTOBER TERM, 1969

JANE LEVIN, on Behalf of Herself and All Others Similarly Situated,

Petitioner,

and

MATILDA BURGER, *et al.*,

Common Stockholders-Intervener-Plaintiffs,

and

SAMUEL MEHLMAN, on Behalf of Himself and All Others Similarly Situated,

Preferred Stockholder Intervener-Plaintiffs,

v.

THE GREAT WESTERN SUGAR COMPANY, *et al.*,

Respondents.

REPLY TO BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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The Great Western Sugar Company, *et al.*,

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REPLY TO BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

I.

The legal issues raised by defendants' conduct.

Respondents claim (RB*25) that the issues in this case are factual and that Petitioner is asking this Court to re-

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* Herein, RB refers to Respondents' Brief in Opposition and Pet. refers to the Petition.

determine the facts. On the contrary, it is the Respondents who seek to turn what are legal questions into factual questions. Petitioner relies only on facts which are undisputed. The Court of Appeals opinion itself states that "the dispute is not as to the basic facts . . ." (Pet. 3A). There is no factual dispute as to the conduct in which the defendants engaged, and on which Petitioner relies for its claim of Rule 10b-5 violation. On Pages 19 through 23 of our Petition are set forth 17 numbered paragraphs reciting undisputed conduct of the defendants. Not a single one of those factual recitals is in any way controverted in Respondents' Brief or in the record.

These undisputed basic facts establish that defendants (a) obtained control of SUGAR through a tender offer with a view to merger, (b) promptly elected their designees as majority directors of SUGAR, and thus took control of both sides of the anticipated merger discussions, (c) had financial interests conflicting with those of SUGAR's public common stockholders, (d) used their dominating position to control formulation of the merger terms, and (e) failed to accord to SUGAR's public common stockholders the benefits of negotiation on their behalf and instead replaced Dillon, Read & Co. as SUGAR's independent financial adviser when Dillon Read found the merger terms unfair to SUGAR's public stockholders.

The issue of whether or not that conduct is culpable, so as to entitle a minority stockholder of the dominated company to challenge the resultant merger as violative of Rule 10b-5 regardless of the "fairness" of the merger terms, is a legal question, and precisely the issue raised by Question 1 of our Petition.

There is, for example, no factual dispute that defendant White (who controlled both SUGAR and MILLING but whose financial interest lay with MILLING) announced to Dillon Read on October 24, 1966, without consulting the SUGAR Board, that if Dillon Read did not think the merger plan fair, another investment banker would have to be found to replace Dillon Read (Pet. 10). Similarly, there is no dispute as to the memorandum (Pet. 10-11) prepared by the President of MILLING's own financial adviser, Standard Research Consultants, Inc. ("SRC") of the November 3, 1966 meeting among defendants White and Maged and SRC representatives. This memorandum and the facts thus memorialized by defendants' own financial adviser are not challenged by Respondents; they are silently ignored. This memorandum reveals that White and Maged, though directors of both MILLING and SUGAR, decided to take Dillon Read off the assignment because it would not approve the merger; that Maged believed that the plan would have to be changed to avoid revealing the Dillon Read turn-down to the S.E.C.; and that the defendants' own financial adviser (SRC), in the privacy of this meeting, counseled that it could not see how SUGAR could *initiate* a merger plan in which the per share earnings of SUGAR's public common stockholders would be diluted, while those of MILLING's shareholders doubled. Yet defendants, though fiduciaries for the SUGAR public stockholders, *accepted* and *recommended* such a merger plan on behalf of SUGAR.

The issue which Question 1 of our Petition raises is whether this and similar undisputed conduct has the legal significance under Rule 10b-5 for which Petitioner contends, wholly apart from the "fairness" of the merger terms. This is not a factual question but a legal question, and one with which the Courts below have failed even to deal.

II.

The legal issues raised by defendants' proxy and the conflict between Circuits.

Petitioner's claim of inadequate proxy disclosure also raises only legal, and not factual, issues, i.e., whether the merger may be challenged by a minority stockholder as violative of Rule 10b-5 regardless of the "fairness" of the merger, where the proxy statement soliciting votes for the merger failed adequately to disclose material undisputed facts regarding control and conflict of interest. It is on a similar question, arising under Section 14(a) of the Securities and Exchange Act of 1934, that this Court, on April 21, 1969 (89 S. Ct. 1470), granted a writ of certiorari to the Court of Appeals for the Seventh Circuit in *Mills and Susman* v. *The Electric Auto-Lite Company,* 403 F. 2d 429 (1968).

Respondents' attempt to distinguish the *Mills* case (RB 29) is fallacious. Respondents concede that in *Mills* the proxy statement was defective because it failed to inform stockholders adequately of the possible adverse interests of those soliciting the proxy. Respondents fail to point out that in *Mills,* as here, the inadequacy of the proxy statement was that though the facts as to control were included elsewhere in the proxy statement, they were not in the section containing the Board's recommendation. On this very basis, the Seventh Circuit concluded that the proxy statement was defective "as a matter of law", 403 F. 2d 429 (432-435). That the same defect exists in the case of the SUGAR proxy statement appears from a reading of the proxy section setting forth the SUGAR Board's recommendations of the merger ("Reasons for the Proposed Merger", DCM5,

p. 5; R1356a*) which omits any reference to MILLING's domination and the lack of independence of the SUGAR Board. The Seventh Circuit's ruling "as a matter of law" in *Mills* is, therefore, squarely in conflict with the Third Circuit's ruling in the instant case that Petitioner's parallel claim of proxy statement inadequacy is "without merit." **

Indeed, the legal insufficiency of the proxy in the subject case is even more egregious. Neither in the Board recommendation section (DCM5, p. 5; R1356a) nor anywhere in the proxy statement is there reference to other undisputed and material facts relating to defendants' control and conflict of interest and the manner in which defendants utilized that control to dominate the shaping of the merger. (See sub-paragraphs (a), (b) and (c) below.) Moreover, the uncontroverted facts also show that much of what is set forth in the recommendation section by the controlled SUGAR Board is misleading or inadequate as a matter of law. (See sub-paragraphs (d) and (e) below):

(a) The Court of Appeals here found that the SUGAR Board which approved the merger plan was one "consisting, except for one member, entirely of Milling designees" (Pet. 5A, 17A). At *no* point in the 100 page SUGAR proxy statement, either in juxtaposition to the Board's recommendation or otherwise, is this simple, telling and crucial fact set forth.

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* Herein, "R" refers to the Appendices filed with the Court of Appeals; numbers preceded by "Tr." refer to pages of transcript of testimony, and numbers preceded by "P", "DCM" or "DGW" refer to exhibits at trial.

** Respondents claim (RB29) that Petitioner's assertion of proxy inadequacy is made for the first time in this Petition. This is a curious and baseless claim, inasmuch as it is apparent from the decisions of the District Court and Court of Appeals that both lower Courts ruled on this point.

(b) Respondents (RB32) seek to justify the omission from the proxy statement of any reference to the uncontroverted conduct of defendants which reflects the use of their control to dominate the shaping of the merger,* on the grounds that there were no findings that this conduct was "culpable." In the first place, whether the conduct itself is culpable under Rule 10b-5 is precisely the legal issue raised by Question 1 of the Petition. Secondly, whether or not independently culpable, the obligation of disclosure in the proxy statement rests not on culpability but on whether its omission renders the proxy statement inadequate "as a matter of law", as in the *Mills* case. In the *Mills* case, the control facts inadequately set forth had nothing to do with culpability. Respondents seem to be urging the strange legal principle that only "culpable" conduct need be set forth in a proxy statement. Adequate proxy disclosure surely requires that public investors be informed of the conduct of their controlling and self-dealing directors so that the public investor may properly evaluate the resultant merger terms and properly weigh the recommendation of those directors.

(c) Respondents concede that when Dillon Read was reapproached, after the Kidder Peabody report had been rendered, it was Dillon Read's judgment that the plan "did not provide a sufficient equity interest for SUGAR common stockholders" (RB18). The proxy statement fails to reveal this, stating only that Dillon Read advised that it could not

* This uncontroverted conduct includes White's decision to replace Dillon Read, defendants' failure as controlling SUGAR directors and stockholders to create effective negotiating procedures, defendants' acceptance on SUGAR's behalf of merger terms which their own advisers felt SUGAR could not initiate, and the other uncontroverted conduct recited in the Petition (Pet. 1-14, 19-23 Pars. 1-17).

"without a new analysis" remove its reservations or express an opinion as to the fairness of the plan (DCM5, p. 9; R1360a). Moreover, the proxy statement (DCM 5, pp. 8-9; R1359a-1360a) fails to state, and indeed obscures, the fact that the re-approach to Dillon Read was made only *after* the MILLING controlled SUGAR Board had already approved the merger in principle and that the purpose of the new approach to Dillon Read was not to obtain their opinion whatever it might be, but only if it were a favorable one that would help effect the merger already determined upon (Pet. 13-14).

(d) Respondents do not challenge the testimony of defendant SUGAR director Sessel (Pet. 25) that there had been no discussion by the SUGAR Board as to whether a merger at all between MILLING and SUGAR was desirable from SUGAR's point of view, but seek to dismiss this telling admission as "isolated and out of context" (RB32). Respondents are completely silent on the admitted failure of the SUGAR Board, Kidder Peabody or anyone else on behalf of SUGAR to check serious questions concerning MILLING's accounting procedures which had been raised by SUGAR's financial advisers (Dillon Read) before their replacement, and which MILLING's financial adviser (SRC) had concededly ignored in formulating the merger terms (Pet. 22, Par. 15). Nor do Respondents deny that the final merger agreement embodied a provision, nowhere present in the written reports of Kidder Peabody or SRC, which reduced the value of the stock going to Petitioner's class by over $4 per share (Pet. 22, Par. 14), a reduction of over $6,000,000 for the SUGAR public common stockholders. Yet, none of these facts are alluded to anywhere in the proxy statement, though the recommendation section contains the naked as-

sertion that the SUGAR Board's conclusion was arrived at "after thorough consideration and study."

(e) The Petition (Pet. 25, Par. 3) points out as false and misleading the statement in the proxy recommendation section that "the combined enterprise will have the benefit of increased total resources. "Respondents' Brief, without reliance on anything in the record, seeks to obscure this, in contradiction of what defendants' own financial statements in the record establish beyond dispute. Respondents' Brief (RB32) states that "the total assets of the merged company (the 'combined enterprise') were the sum of the separate assets of MILLING and SUGAR prior to the merger." This is simply not true. The assets of the merged company were $162,909,000, whereas the sum of the separate assets of MILLING and SUGAR pre-merger was $196,288,000 (DCM5, p. 15; R1366a). Moreover, the term "resources" used in the recommendation section plainly refers to net assets (i.e., assets minus liabilities), which were also decreased by the merger. The net assets of the merged company were $77,660,000, whereas pre-merger the net assets of SUGAR alone were $94,179,000 and those of MILLING and SUGAR were $117,707,000 (DCM15, p. 15; R1366a). This decrease, rather than increase, in resources was not unknown to defendants, since it resulted directly from the steps they took to obtain control of SUGAR. MILLING's greatest single asset, pre-merger, was its $36,603,000 investment in the control stock of SUGAR, for the acquisition of which it had borrowed $37,290,000 from banks. The effect of the merger was to eliminate MILLING's principal asset, but to leave the debt as a charge against the merged company's assets, thus bringing down the merged company's net assets to a figure $17,000,000 below those of SUGAR alone, pre-merger.

(f) The Petition (Pet. 25-26, Par. 4) cited uncontroverted testimony of the SUGAR President and of defendants' own expert at trial, both of whom testified that the merger would *not* produce any *benefits* from greater depth of management, revealing as false and misleading the statement in the proxy recommendation section that one of the "benefits" of the merger would be "greater depth of management." Respondents (RB32) do not challenge the uncontroverted testimony, but blandly assert counsel's opinion that "Greater depth of management would clearly result." However, even Respondents' counsel stop short of asserting that this would produce "benefits" as claimed in the proxy statement.

III.

The proper legal test of fairness in a merger of a controlled and controlling company.

Respondents concede (RB33) that application of the business judgment rule in appraising the fairness of a merger between a controlled and controlling company would not be proper and that the correct legal standard would be that the merger must be set aside if in the slightest degree unfair.

Respondents' brief does not challenge the undisputed facts set forth on pages 29 to 31 of the Petition, which plainly show that this correct legal standard was not met.

Instead, Respondents rely on quotation from the opinion of the District Court, which states its agreement with what Petitioner contends, and Respondents concede, is the correct legal standard. The error of the District Court was

its failure correctly to apply those standards to the undisputed facts. In the Court of Appeals' opinion, this standard was not even proclaimed, let alone applied; and it is apparent from a reading of the Circuit Court opinion that it weighed the pros and cons of the merger in a manner relevant only to application of the improper business judgment rule.

Respondents' Brief begs the essential issue raised by Question 3 of the Petition by merely repeating the "pros" which would be relevant to application of the business judgment rule; they deal not at all with the "cons" (Pet. 6-7, 28-31), which require a determination of unfairness if the test is, as Respondents admit, whether the merger is "in the slightest degree unfair or fails to carry the earmarks of an arm's length bargain."

IV.

The important questions of federal law and their public significance.

Respondents' Brief (RB27-28) asserts that the "case is of no public importance" and that the Petition raises "no important question of federal law."

On the contrary, the Petition raises, on undisputed facts, basic issues of federal law under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. In the entire field of corporate democracy, it is difficult to conceive of legal issues having greater public importance during this era of tenders, take-overs and mergers.

In mergers between controlling and dominated companies, it must be made clear that under Rule 10b-5 those fiduciaries in control and occupying a conflict of interest position have the responsibility of adopting procedures which will insulate the formulation of the merger terms from their domination and control; and that the proxy statement of the dominated company must, as a matter of law, adequately disclose the facts of control and conflict of interest, and also the conduct of the fiduciaries in the use of that control. Also to be made clear is that Rule 10b-5 requires that the merger terms be not merely defensible on the basis of the uncertain prognostications of financial experts, but be wholly free from the slightest degree of unfairness or from any failure to carry the earmarks of an arm's length bargain.

The critical public need for establishment of these rules by this Court is dramatically demonstrated by this case.

The Court of Appeals acknowledged that it "is most difficult to pass" on the issue of fairness and that the key justification for the merger was the "caliber of management and [MILLING's] corporate growth potential." For this justification it relied heavily upon the assumption that the earnings trend over a five year period portended greater future earnings prospects for MILLING than for SUGAR—despite the fact that the Kidder Peabody report (which the Court of Appeals itself stated must be the principal justification for the merger (Pet. 8A)) projected greater earnings growth for SUGAR than for MILLING (Pet. 29-30, Par. (b)). Respondents' Brief continues to emphasize reliance on what Respondents contend is "the generally increasing trend of MILLING's earnings compared to the decreasing trend of SUGAR's earnings" (RB35).

That this major justification for "fairness" of the merger terms was a fiction is revealed by an article in the July 2, 1969 issue of *The Wall Street Journal,* which we reprint following this paragraph. We quote the article not as a factual argument that the merger terms were unfair, since we recognize that it is not a part of the record in this case and was published after the merger took place. We refer to it rather to emphasize the fundamental truth that, in a control situation, fair conduct and procedures, insulated from the domination of the self-dealing directors, and the fullest proxy disclosure of the fiduciaries' conduct, are essential to protect the public stockholders of the dominated company. Reliance cannot be placed upon the prophesies of financial experts retained for the occasion. The full text of this article follows:

GREAT WESTERN UNITED IS CONSIDERING SELLING COLORADO MILLING UNIT

NO NEGOTIATIONS ARE IN PROGRESS; PLAN VIEWED AS BID BY PARENT TO BOLSTER PER-SHARE PROFIT

By a WALL STREET JOURNAL *Staff Reporter*

DENVER—Great Western United Corp. said it "is considering plans to sell" Colorado Milling & Elevator Co., a wholly owned subsidiary that makes wheat flour.

A company spokesman said that there aren't any negotiations for the sale in progress and no price has been set.

William M. White Jr., a New York investment banker, gained control of Colorado Milling in 1965 through a tender offer. Two years later, he merged it with Great Western Sugar Co., also of Denver, to form

Great Western United. The company has since acquired interests in land development, food research, Christmas trees and pizza parlors.

The 30-year-old Mr. White said yesterday that "although Colorado Milling has enjoyed one of its most successful years," he was considering its sale "because the stable and basic bakery flour business isn't in pattern with the evolution of Great Western United into a creative marketing company with interests in consumer-oriented growth areas."

Mr. White, who is Great Western United's chief executive officer, added that Colorado Milling has recently "disposed of its marginal flour and feed mills and transferred the consumer product operations of the company to a separate consumer marketing division," the Great Western Foods Co.

Colorado Milling sells flour commercially in about 26 states, with most sales concentrated in the Rocky Mountain and West Coast markets. It operates five flour mills in Idaho, Utah and Colorado.

Mr. White said that Great Western's board had authorized management to consider "the ways and means, including stockholders' approval where necessary," to dispose of Colorado Milling.

Financial analysts in New York and elsewhere interpreted the announcement by Mr. White as a move to increase per-share earnings, market value and the rate of return of capital.

"Great Western United's earnings in the last two years have tended to disappoint Wall Street," said one analyst. "They've been a couple of dollars below what's been expected. The sale of Colorado Milling, which has sub-average potential and only moderate earnings, shouldn't hurt earnings and it should free the company to get into more profitable areas," he added.

Another analyst said that Great Western's share price, currently about 10 times annual per-share earnings, "has been pulled down by Colorado Milling, a

not-very-glamorous company in a not-very-glamorous business."

The plan to sell Colorado Milling is probably a good idea in terms of upgrading long-term earnings growth and the rate of return of capital," said Matthew Levison, a financial analyst with Abbott, Proctor & Paine in New York.

Great Western United has predicted it will report earnings rose to about $16.2 million, or about $5.50 a share on current common, or $5.35 a share on a fully diluted basis, in the fiscal year ended May 31. The company has said fiscal 1969 sales were about $234 million, including about $50 million from Colorado Milling. Profit, but not sales, projections for fiscal 1969 include earnings on an equity basis of California City Development Co. and 36 related companies recently acquired by Great Western United.

In fiscal 1968, Great Western had net income (after a $1,562,000 extraordinary item covering losses resulting from the closing of the marginal flour and feed mills) of $7 million, or $2.02 a share, on sales of $258.9 million.

The turn of events reflected by this article is, of course, entirely consistent not only with Petitioner's contention throughout, but also with defendant White's own prediction, when he sought bank financing of MILLING's tender for control of SUGAR, that SUGAR "provides a higher return on sales and investment than is possible from flour milling" (Exh. P14, R1475a)—a contention and prediction totally disregarded by both lower Courts.